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No. 579

# In the Supreme Court of the United States

OCTOBER TERM, 1933

CHARLES ILFELD COMPANY, PETITIONER

*vs.*

B. C. HERNANDEZ, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF NEW MEXICO

*ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT*

## BRIEF FOR PETITIONER

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## BRIEF FOR PETITIONER

### OPINIONS BELOW

No written opinion was rendered by the District Court. That court's findings of fact and conclusions of law will be found in the record at pp. 19 to 25. The original opinion of the Circuit Court of Appeals for the Tenth Circuit (R. 111-120) is reported in 66 Federal (2d) p. 236. An opinion rendered on the Petition for Rehearing (R. 125-129) is reported in 67 Federal (2d) p. 236. The judgment of the Circuit Court of Appeals for the Tenth Circuit was entered July 13th, 1933 (R. 120-121) and Petition for rehearing was filed August 10th, 1933 (R. 121-124) and was denied on the 10th day of October, 1933 (R. 125-129). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

## STATEMENT OF THE CASE

Petitioner brought this suit in the District Court for New Mexico, for the recovery of income tax paid for the year 1929 (R. 1-4). Jury trial was waived in writing (R. 11) and the Court made Findings of Fact and Conclusions of Law (R. 19-25). The findings may be summarized as follows:

Petitioner purchased all of the capital stock of the Springer Trading Company in 1917 and all of the capital stock of Roy Trading Company in 1920, and operated both corporations as affiliated or subsidiary corporations from the dates of such purchase up to and including the month of November, 1929. During such years of operation, the petitioner filed consolidated returns and offset the operating losses of its said subsidiaries against its, the parent's, operating profits during the period of affiliation (R. 19-22),

The petitioner paid the sum of $40,000.00 for the Springer Trading Company stock and during the period from 1917 to 1929 advanced and loaned to the latter company, the sum of $69,030.27. During the year 1929 up to and including the month of November, the Springer Trading Company liquidated and sold all of its assets to outside interests and paid off all its obligations. On the 23d of December, 1929, the Springer Trading Company turned over to the petitioner, the cash proceeds derived from liquidation in the sum of $22,914.22. Petitioner sustained a loss on its capital investment in the Springer Trading Company in the sum of $86,116.05, which was charged off

the petitioner's books as a loss on the 31st day of December, 1929 (Finding of Fact No. 2; R. 20-21). The petitioner paid the sum of $50,000.00 for the Roy Trading Company stock and during the period from 1920 to 1929 advanced and loaned the latter company the sum of $9,782.22. During the year 1929, up to and including the month of November, the Roy Trading Company liquidated and sold all of its assets to outside interests and paid all of its obligations. On December 23d, 1929, the Roy Trading Company turned over to the petitioner the cash proceeds derived, the sum of $15,106.16. The petitioner sustained a loss on its capital investment in the Roy Trading Company in the sum of $44,676.06, which was charged off petitioner's books as a loss, as of December 31, 1929 (R. 21, Finding of Fact No. 3). Both the Springer Trading and the Roy Trading Companies were liquidated and dissolved in the month of November, 1929 (R. 21—Finding of Fact No. 4).*

*It was stipulated and agreed by the parties in the trial Court (R. 26-27) that the audit made by the Treasury Department (plaintiff's Exhibit "A") and which contains the ruling of the Respondent, denying petitioner's claim, should be received in evidence as to the facts and figures governing this cause, except that the petitioner did not agree with the conclusions of law in such report, nor to the method by which the loss sustained by the petitioner was charged off. The Court's finding that the subsidiaries were liquidated and dissolved in November is based on the auditor's report, and the commissioner's rulings thereon (R. 30) wherein the report reads:

"Charles Ilfeld Company owned one hundred per cent of the capital stock of each of the two subsidiaries until they were liquidated and dissolved in November, 1929," and on the undisputed testimony of the witness Rodney B. Horton (R. 52-53).

In the year 1930, the petitioner filed its consolidated returns covering its operations and those of the Roy and Springer Trading Companies, without deducting the losses sustained by it on liquidation and dissolution of the two subsidiaries and paid to the Collector of Internal Revenue the sum of $20,836.20 in equal quarterly installments (R. 22 Finding of Fact No. 5). Thereafter, in May, 1931, the petitioner filed an amended return and claim for refund for the year 1929, setting up these losses as deductible which was, by the Commissioner of Internal Revenue of the United States, disallowed on the 28th day of January, 1932. (R. 22 Finding of Fact No. 5).

The petitioner has claimed and been allowed in the aggregate, as deductions from its own net operating income for the taxable years 1918 to 1928 inclusive, the operating losses of its subsidiaries during that period, the total sum of $131,424.41 and charged with and taxed upon operating profits of said subsidiaries in the total sum of $12,913.88, or allowed aggregate net deductions from its own taxable net income of $118,510.53 on account of operating losses sustained by the Springer Trading Company (R. 23; Finding of Fact No. 7).

Petitioner has claimed and been allowed, in the aggregate, as deductions from its own net current operating income for the taxable years 1920 to 1929, inclusive, a total sum of $61,535.17 and charged with and taxed upon the profits in the total sum of $4,407.32 or allowed aggregate net deductions from its own taxable

net income of $58,127.85 on account of the operating losses sustained by the Roy Trading Company (R. 23-24 Finding of Fact No. 8).

The Court found the allegations of the petitioner's complaint to be true and the issues generally in favor of the petitioner (R. 24, Finding of Fact No. 9) and rendered judgment for the petitioner in the sum of $14,460.43 with interest (R. 25).

From the foregoing Findings of Fact, the trial court made the following Conclusions of Law (R. 24):

**CONCLUSION OF LAW NO. 1**

That the liquidating dividends paid over by the subsidiary corporations, the Springer Trading Company and the Roy Trading Company, to the plaintiff in the month of December, were not paid over in cancellation or redemption of any part or portion of the stock of said corporations, nor was such payment in either instance an inter-company transaction.

**CONCLUSION OF LAW NO. 2**

That the period of time from January first, 1929, up to and including the month of November, 1929, when the affiliations between the two subsidiary companies and the plaintiff parent corporation were broken by liquidation, constituted a consolidated return period; and the payment over of the liquidating dividends by said subsidiary companies in December, 1929, was not made during a consolidated return period.

The commissioner charged the petitioner's capital losses on its investment in the subsidiaries to the par-

## SPECIFICATIONS OF ASSIGNED ERRORS

The Circuit Court of Appeals erred in reversing the United States District Court of New Mexico in the following particulars:

I.

The Circuit Court of Appeals erred in finding and holding that, irrespective of Treasury Regulations 75 promulgated by the Treasury Department under statutory authority (Section 2141 Title 26 U.S.C.A.) the petitioner herein was not entitled to deduct the losses sustained by it on its capital investment in its subsidiaries; and in refusing to hold that since the Revenue Act of 1928, Section 2141 Title 26 U.S.C.A. imposed upon corporations making consolidated returns the following:

> "The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which return is made, consent to all the regulations under subsection (b) prescribed prior to the making of such returns; and the making of such a consolidated return shall be considered as such consent,"

the Commissioner was not bound to allow the deductible loss here claimed under the provisions of Paragraph 2 of subdivision (c) of Article 34, Regulations 75, quoted in Appendix. (p. 38); and in refusing to hold that both the government and the petitioner were bound by the applicable provisions of Regulations 75 and denying petitioner's loss, when the express provisions require the allowance of the loss sustained by the petitioner in the year 1929 without reduction on

account of operating losses sustained by the subsidiaries in the years prior to 1929.

II.

The Circuit Court of Appeals erred in denying petitioner's loss which it suffered on the investment of its subsidiaries, to-wit: The Springer Trading Company in the sum of $86,116.05 and the Roy Trading Company in the sum of $44,676.06 with interest; and in holding and finding such claimed loss would be a double deduction.

SUMMARY.

Both parties to this cause agree that this case is governed by Section 141 (a) of the Revenue Act of 1928,—Section 2141, Title 26, U. S. C. A. set forth at length in the appendix (p. 35), and the rules of the Treasury Department, Regulations 75, promulgated by the authority of the statute. The petitioner contends that this cause is governed by subdivision (b)[1] of Article 37, Regulations 75 and paragraph 2 of subdivision (c)[2] of Article 34. The respondent in

[1] Art. 37 (b): "Any such distribution after a consolidated return period, whether in complete or partial liquidation after a consolidated return period, shall be treated as a sale of the stock, and the adjustments specified in articles 34 and 35 will be made, and article 36 will be applicable."

[2] Art. 34 (c) Par. 2: "From the sum of the aggregate bases, as determined in Paragraph (1) above, there shall be deducted the aggregate of the losses of such issuing corporation sustained during each of the consolidated return periods (including only the taxable year 1929 and subsequent taxable years) after such corporation became a member of the group and prior to the sale of the stock to the extent that such losses could not have been availed of by such corporation as a net loss in computing its tax for such periods if it had made a separate return for each of such periods."

both the trial and Circuit Courts and in its brief opposing the Writ of Certiorari, in this Court, contended that this cause is governed by Subdivision (a) of Article 37* Regulations 75.

There are no decisions interpreting Section 2141 Title 26 U. S. C. A. or the rules governing consolidated returns promulgated thereunder by this Court, and the decision of the Circuit Court in this cause is the only decision, ruling on said statute, and the rules promulgated thereunder, so far as this petitioner is advised.

The Circuit Court of Appeals held that the payment of the liquidating dividends was not an intercompany transaction, but reversed the trial court on the ground that the operating losses of the subsidiaries during affiliation having been offset against the operating income of the parent, it would be a double deduction to permit the parent to charge off its loss on its investment in the subsidiaries on liquidation, after affiliation was broken.

## ARGUMENT

## SPECIFICATION OF ASSIGNED ERROR NO. I

**The Circuit Court of Appeals erred in finding and holding that, irrespective of Treasury Regulations 75 promulgated by the Treasury Department under statutory authority (Section 2141 Title 26 U. S. C. A.) the**

*Art. 37 (a): "Gain or loss shall not be recognized upon a distribution during a consolidated return period, by a member of an affiliated group to another member of such group, in cancellation or redemption of all or any portion of its stock; and any such distribution shall be considered an intercompany transaction."

**petitioner herein was not entitled to deduct the losses sustained by it on its capital investment in its subsidiaries; and in refusing to hold that since the Revenue Act of 1928, Section 2141 Title 26, U. S. C. A. imposed on corporations making consolidated returns the following:**

> **"The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which return is made, consent to all the regulations under subsection (b) prescribed prior to the making of such returns; and the making of such a consolidated return shall be considered as such consent."**

**the commissioner was not bound to allow the deductible loss here claimed under the provisions of Paragraph 2 of subdivision (c) of Article 34 Regulations 75 (quoted in Appendix p. 38) and in refusing to hold that both the government and the petitioner were bound by the applicable provisions of Regulations 75 and that the express provisions of Regulations 75 require the allowance of the loss sustained by the petitioner in the year 1929 without reduction on account of operating losses sustained by the subsidiaries in the years prior to 1929.**

Prior to 1929, regulations promulgated by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, did not prevent the Government from taking a position contrary to their provisions, as is evidenced by numerous retroactive changes in the regulations, later sustained by

the courts. With respect to the regulations promulgated by the commissioner governing the tax liability of affiliated corporations for the year 1929 and subsequent years, the situation is made entirely different by express statutory provision. Section 141 (a) of the Revenue Act of 1928—Section 2141 Title 26, U. S. C. A. gives affiliated groups of corporations the privilege of making consolidated returns for the year 1929 and further provides:

> "The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (b) prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent."

This makes the provisions of the regulations binding upon affiliated corporations filing a consolidated return for the year 1929. Likewise, the government is bound by the provisions of the regulations, Section 141 (c) providing:

> "In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected and adjusted in accordance with the regulations under subsection (b) prescribed prior to the date on which such return is made."

It will be observed that in each of the excerpts above quoted, it was carefully provided that the regulations in accordance with which the tax must be determined

shall have been prescribed prior to the date on which the return is made. For this reason the consolidated returns regulations prescribed by the commissioner under Section 141 are frequently spoken of as contractual. The bargain cannot be varied by either party.

That this was the object of Congress in enacting Section 141 is shown by the report of the Senate Committee on Finance (Senate Report 960, 70th Congress, First Session) at page 15:

> "The committee believes it to be impractible to attempt by legislation to prescribe the various detailed and complicated rules necessary to meet the many differing and complicated situations. Accordingly, it has found it necessary to delegate power to the commissioner to prescribe regulations legislative in character covering them."

Regulations 75 prescribed by the commissioner in accordance with the authority granted in Section 141 (b) recognizes the obligation of the government to be bound by its provisions. Article 1 (b) provides:

> "The tax liability of the members of the affiliated group for such year will be determined in accordance with such regulations and without regard to any amendment thereto promulgated subsequent to the filing of such return."

The Commissioner thus expressly disclaims the right to make retroactive changes in the consolidated regulations for 1929. Nor has he attempted to do so in this case. The provisions of Regulations 78, prescribed under Section 141 of Revenue Act of 1932, gov-

erning consolidated returns for 1932 and subsequent years, so far as they relate to the problem presented in this case, are not different from the corresponding provisions of Regulations 75. Moreover, the commissioner expressly states in Regulations 78 under the heading "Application of Regulations": "The regulations applicable to the taxable years 1929, 1930 and 1931 will be *found in Regulations 75.*"

The problem presented by this case is therefore governed solely by the applicable provisions of Regulations 75.

The very first of many difficult and complicated problems arising in the administration of consolidated returns provisions on which the Congress intended to delegate power to the commissioner to prescribe regulations legislative in character was the problem presented by the instant case. When the commissioner promulgated Regulations 75 he departed from, we think, an unvarying precedent, and quoted in support of his authority to prescribe regulations the statement made in the report of the Committee on Finance above referred to (noting also a similar statement of the managers on the part of the House), beginning as follows:

> "Among the regulations which it is expected that the commissioner will prescribe are: (1) The extent to which gain or loss shall be recognized upon the sale by a member of the affiliated group of stock issued by any other member of the affiliated group or upon dissolution (whether partial or complete) of a member of the group; * * * "

Carrying out the desire of Congress, thus expressed, that he legislate upon this subject, the Commissioner provided in Regulations 75 the precise method of calculating the taxable gain or deductible loss resulting to a corporation whose subsidiary is dissolved in the taxable year 1929. Article 37 deals with "Dissolutions—Recognition of Gain or Loss." As the opinion of the *Circuit Court demonstrates, the transaction out of* which the claimed loss arose did not occur during the consolidated return period, the affiliation having been terminated prior to liquidation, and therefore is not to be disregarded as having arisen upon a distribution required under Article 37 (a) to be considered an intercompany transaction. Since the distribution occurred after the consolidated return period, Article 37 (b) is in terms applicable:

> "Any such distribution after a consolidated return period, whether in complete or partial liquidation, shall be treated as a sale of the stock, and the adjustments specified in articles 34 and 35 will be made, and article 36 will be applicable."
>
> Article 36 has no bearing in this case.

The adjustments specified in Article 34 (which affects the determination of the loss on the stock investment of the petitioner, while Article 35 affects the determination of the loss on the intercompany accounts receivable) are contained, so far as applicable to the facts of this case in paragraph 2, subdivision (c). Subdivision (c) paragraph 2 prescribes the ordinary basis for determining gain or loss, with a provision for

an aggregate basis where several affiliated corporations own the stock of the issuing corporation concerned, and provides for the following adjustment:

> "(2) From the sum of the aggregate bases, as determined in paragraph (1) above, there shall be deducted the aggregate of the losses of such issuing corporation sustained during each of the consolidated return periods (including only the taxable year 1929 and subsequent taxable years) after such corporation became a member of the group and prior to the sale of the stock, to the extent that such losses could not have been availed of by such corporation as a net loss in computing its tax for such periods if it had made a separate return for each of such periods."

It is impossible to spell out more plainly than in the words of this regulation that no part of any losses sustained by the issuing corporation (the liquidation subsidiaries) for 1928 or any prior year is to be deducted from the basis for determining gain or loss on the liquidation. To hold otherwise would be to write the word "only" out of the regulation.

The losses sustained by reason of the non-payment of advances made by the petitioner to the subsidiaries liquidated in 1929 stand on the same footing as the losses sustained upon the stock investment. Article 40, Regulations 75, entitled "Bad Debts" provides in paragraph (c), "Limitation on Allowance after Consolidated Return Period":

> "The rules applicable to the allowance of losses upon the sale of bonds shall be applicable to the al-

lowance after the consolidated return period as a bad debt of an intercompany account receivable or other obligation resulting from an intercompany transaction during the consolidated return period. (See Art. 35)."

Article 35, entitled "Sale of Bonds—Basis for determining Gain or Loss," provides for determining the basis of each bond in accordance with the act, adding:

"but the amount of any loss otherwise allowable shall be decreased by the excess (if any) of the aggregate of the deductions computed under paragraph (c) (2) of article 34 over the aggregate of the basis of the stock of the issuing corporation as computed under paragraph (c) (1) or (d) as the case be, held by the members of the affiliated group."

As we have shown above, no deduction is to be made under paragraph (c) (2) of Article 34 from the basis of stock on account of operating losses of the issuing corporations for years prior to 1929, and there is no excess of such deductions available to reduce the basis of bonds, and therefore of these intercompany accounts receivable, under the present circumstances.

It follows that the losses sustained by the petitioner on both the stock and the intercompany accounts receivable are unaffected by operating losses of the subsidiaries unless they occurred in the taxable year 1929.

The lower court, in its decision on the Petition for Rehearing, (R. 126) said:

"Counsel for appellee, upon the assumption that we held that section 37 (b) was applicable, now di-

Treasury rules in the instant case is neither unjust nor anomalous. Had the subsidiaries made a profit and been taxed through the affiliated years, they would have been again taxed on liquidation. "What is sauce for the goose should be sauce for the gander" to borrow one of the many sapient epigrams found in the opinions of the Circuit Court. *Remington Rand, Inc.* v. *Commissioner*, (C.C.A.) 33 Federal (2d) 77, certiorari denied in 280 U. S. 59[illegible], 50 Sup. Ct. 39, 74 L. Ed. 639. As to the rules being applicable only to the taxable year of 1929 and subsequent taxable years, there is nothing anomalous about that. It is customary to fix income tax liability along arbitrary lines. The Revenue Act of 1928, Section 2141 Title 26 U.S.C.A. Paragraph (a),* was designed to mark a new departure in consolidated returns and marks the beginning for the year of 1929 arbitrarily. The rate that corporations shall pay is arbitrarily fixed, as well as that of individuals. The Circuit Court said in its second opinion (R. 127):

> "At any rate, if Article 37 (b) is applicable the Commissioner must first determine and adjust the bases of the stock immediately prior to the sale. A strong burden was cast upon appellee to prove that the Commissioner erred in determining and adjusting the bases of the stock as required by Section 34. There is no finding by the trial court as to the ad-

*Paragraph (a): "An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year 1929 or any subsequent taxable year in lieu of separate returns."

justed bases of the stock, nor any conclusion that the commissioner erred in that regard. Without such proof, the commissioner's determination cannot be set aside."

The statement of the Circuit Court in this respect is not borne out by the record. The trial court determined the amount of capital investment which the petitioner made in the subsidiaries and the loss it suffered thereon (Finding of Fact No.'s 1, 2, and 3; R. 19, 20, 21).

So did the respondent commissioner. (See Petitioner's Exhibit "A"; R. 31).

The commissioner arbitrarily ruled as follows:

"However this is a 1929 transaction and by no stretch of the imagination can it be considered other than a winding up dissolution and as per article 37 (a) Regulations 75:

'Gain or loss shall not be recognized upon a distribution during a consolidated return period, by a member of an affiliated group to another member of such group, in cancellation or redemption of all or any portion of its stock; and any such distribution shall be considered an intercompany transaction.'

The facts established that the distribution and liquidation in question occurred during the consolidated period.

Article 40 (a) Regulations 75 also reads as follows:

'Intercompany accounts receivable or other obligations which are the result of intercompany

transactions during a consolidated return period shall not be deducted as bad debts during a consolidated return period.' "

It is manifest from this ruling of the commissioner that he did not consider the bases but relied entirely upon Article 37 (a) Regulations 75. He decided that the liquidating dividend paid over to the parent was an intercompany transaction. That this was the position of the commissioner is further evidenced by the Answer filed in the trial court (Subdivision 4, of Paragraph 4; R. 8) wherein the Commissioner in his Answer alleged:

"That the liquidation of the said Springer Trading Company and the said Roy Trading Company as alleged in the plaintiff's complaint, constituted distribution during a consolidated return period within the meaning of the provisions of Section 37, Article A of Regulations 75 quoted above; and that the same constituted an intercompany transaction for which no account or loss can be recognized."

The respondent bases his contention that subdivision (a) of Article 37 Regulations 75 is controlling because the record shows the stock was voted at a meeting held for the purpose of formally dissolving the subsidiaries on December 30, 1929 (R. 53). But the respondent found that the subsidiaries were liquidated and dissolved in November (R. 30) and the loss of the petitioner on its capital investment in the subsidiaries was charged off as of December 31, 1929 (R. 52). The undisputed evidence discloses that the payment of the

liquidating dividend was not in payment or cancellation of the subsidiaries' stock (R. 52) and the trial court so concluded (R. 24). The true intent and purpose of subdivision (a) Article 37 Regulations 75 is to forbid and prevent the cancellation or redemption of stock in subsidiaries at fictitious values to prevent the pyramiding of losses by cancelling or redeeming stock of subsidiaries at fictitious values. There can be no contention that any attempt was or is being made in the instant case to pyramid losses or take up stock at fictitious values.

## SPECIFICATION OF ASSIGNED ERROR NO. II

**The Circuit Court of Appeals erred in denying petitioner's loss which it suffered in the investment of its subsidiaries to-wit: The Springer Trading Company in the sum of $86,116.05 and the Roy Trading Company in the sum of $44,676.06 with interest; and in holding and finding such loss to be a double deduction.**

The Court below based its decision on the ground that the Petitioner was seeking double deduction and claiming that it was lawfully entitled to a double deduction, solely by reason of the provisions of Regulations 75. The petitioner has contended in both the lower courts and now contends, that it is not seeking a double deduction. Manifestly, there was no actual return of the capital to the petitioner, nor was there the equivalent of such return in the amount of the operating losses. For example, under the consolidated returns for previous years, the Springer Trading Com-

pany's operating loss, as it appeared year by year, was taken into account but the inclusion of that loss in the yearly consolidated return did not reimburse the Charles Ilfeld Company for any part of the $109,030.27 capital investment made and the $86,116.05 lost in the operation of this subsidiary. The most that can be said is that the Charles Ilfeld Company benefited over the years of affiliation by having its own taxes reduced according to the rate charged, which varied almost every year. But there was not, under any conceivable theory, a return to the Charles Ilfeld Company, of even that amount on account of its investment. In order to determine the exact amount which the petitioner benefited by reason of offsetting the current annual operating losses of the subsidiaries against the current annual operating profits of the parent, it would be necessary to go back and determine the amount in dollars and cents so offset, multiplied by the varying rates fixed for corporations, for each particular year for the entire affiliated period. Had the subsidiary corporations earned the sum of $130,792.11 instead of losing it, such profit would, on liquidation in 1929, have been taxed the exact amount the surplus was thereby augmented, although during the period of making consolidated returns, it had been annually taxed on this same profit. *Remington Rand, Inc.* v. *Commissioner* 33 Federal (2d) 77, 280 U. S. 591, 50 Sup. Ct. 39, 74 L. Ed. 639. The Treasury Department, since the decision of the Circuit Court in this case, has accordingly

ruled and instructed collectors generally as follows: (Commerce Clearing House reports):

"Reference is made to the decision of the Circuit Court of Appeals, 10th Circuit, in the case of Hernandez v. Charles Ilfeld Company, decided July 13, 1933, C.C.H. 1933 Volume 3, page 9122, P.H. 1933 page 2193, paragraph 1512. A petition for rehearing of this case has been filed.

Inasmuch as that part of this decision which permits a deduction for a loss resulting from a liquidation of a subsidiary corporation is in conflict with the Bureau's interpretation of Article 37 (a) of Regulations 75, it is considered advisable, pending final settlement of this question, to adopt the policy of taxing gains, but not recognizing losses on such liquidations. Reports from your division should be prepared in accordance with this policy until the interpretation of Article 37 (a) is definitely determined."

There is no necessary correlation between the taxation of operating profits, or the deduction of operating losses by a corporation and the taxation of gains or the deduction of losses by a stockholder from his investment in it. Whether or not the corporation's gains or losses are reflected in the price the stockholder pays or receives for his stock, the income tax law treats the two taxpayers, the corporation and the stockholder, as entirely separate, and taxes their gains independently. Thus X Corporation may have had operating profits of $1,000,000, on all of which it has paid the tax. As a result of these profitable operations, the shares of stock in X owned by A may have advanced from their

cost of $100,000 to a market value of $200,000. If X corporation is liquidated and A receives $200,000 as his dividend, A will be compelled to pay an income tax on $100,000 profit, irrespective of the fact that the X corporation has previously paid a tax on these same profits as earned. This Court has held that this double taxation is not invalid, *Hellmich v. Hellman* (276 U. S., 233). The converse is also true. As was said in the case of *United Publishers Corporation* v. *Anderson* reported in 42 Federal (2d) p. 781:

> "In principle this case cannot be distinguished from Remington Rand, Inc. v. Commissioner of Internal Revenue (CCA) 33 Federal (2d) 77, certiorari denied 280 U. S. 591, 50 Sup. Ct. 39, 74 L. Ed. 639. It was there held that where a parent corporation sold its stockholdings in a subsidiary, the excess of the selling price over the cost of the stock was taxable as a profit realized by the parent. The fact that the parent had for several years filed consolidated returns was held immaterial, as was also the fact that the subsidiary had accumulated earnings during these years, which earnings had been included in the consolidated earnings and thus taxed. The Government's contention was upheld in both respects. Here we have the exact converse. Here the sale of the stock was at a loss, and the operations of the subsidiary had been conducted at a loss over the years when consolidated returns were filed. The taxpayer is therefore warranted in insisting: first, that upon the sale of the Journal of Commerce stock it suffered a loss of $161,091.85, to the same effect as upon the sale of any other property; and, second, that the fact that the Journal of Commerce Com-

pany's operating losses had been taken advantage of by the plaintiff in its payment of taxes on the consolidated basis is of no consequence."

The Tenth Circuit Court of Appeals disposes of this contention, in its original opinion (R. 118) by saying:

"The plaintiff argues that since in arriving at capital gain, operating profits which have been returned for taxes are not taken into the equation, operating losses which have been allowed as deductions should not be considered. There is some logic and convenience in a clear separation of capital losses from operating losses. There is rough equity in the plaintiff's position that what is sauce for the goose should be sauce for the gander.".

It is well established that the provisions authorizing consolidated returns do not change the substantive law to make the affiliated group into a single corporation. They authorize merely a form or method of reporting income. The affiliated corporations remain separate entities, but their respective incomes and deductions are reported on a single return. Thus it has been frequently held that the liability to pay the tax rests upon the several affiliated corporations individually. As the Supreme Court said in *Woolford Realty Company* v. *Rose* 286, U. S. 319:

". . . . The fact is not to be ignored that each of two or more corporations joining (under Sec. 240) in a consolidated return is none the less a taxpayer. Commissioner of Internal Revenue v. Ben Ginsberg Co. (C. C. A. 2d) 54 Fed. (2d) 238,239. By the express terms of the statute (Sec. 240 B) the tax when

computed is to be assessed, in the absence of agreement to the contrary, upon the respective affiliated corporations 'on the basis of the net income properly assignable to each.' 'The term "taxpayer" means any person subject to a tax, imposed by this Act.' Revenue Act of 1926, Sec. 2 a (9) (U.S.C.A. Title 26, Sec. 1262). A corporation does not cease to be such a person by affiliating with another." (at p. 328).

In the latter case, it was held that a parent corporation could not deduct on a consolidated return net losses of a subsidiary sustained before affiliation. Even, if the subsidiaries' losses were sustained during affiliation, it has been uniformly held, following the *Woolford* case, that the net losses cannot be applied against the income of the parent in a subsequent year. See: *Delaware & Hudson Co.* v. *Commr.* 65 Fed. (2d) 292. The two corporations are regarded as separate entities and the net loss of the one cannot be carried forward and applied against the income of the other in a later year.

Consequently, when deductions were taken in the consolidated return for the operating losses of two subsidiary corporations, the deductions belonged to those corporations and were taken by them. The parent corporation obtained a benefit from the loss, only by virtue of the statute, whereby the parent was permitted to offset the loss of another taxpayer against its own income. The parent suffered no loss of its own until it liquidated the two subsidiaries in 1929. In that year, it unquestionably did suffer a loss on its investment in the subsidiaries' stock. The fact that the sub-

sidiaries had previously had operating losses or had been permitted by Congress to report them in a consolidated return has no bearing upon the reality or the deductibility of the parent's own loss on its investment. This is well brought out in the recent case of *Burnet* v. *Imperial Elevator Company* 66 Federal (2d) 643. In that case, a subsidiary had had operating losses which were deducted on consolidated returns for prior years. In 1923, the subsidiary was liquidated, the parent receiving nothing on the liquidation. It, therefore, deducted the full cost of the stock in the subsidiary in that year, and sought to carry it forward as a net loss. The commissioner urged that the parent was attempting to obtain a double deduction. The Court held that the deduction was allowable, saying:

> "Operating losses of the subsidiary are, obviously different from losses on the stock held by the tax payer, and the Board expressly finds that no deduction was taken for the stock loss in that year."

In the instant case, both the trial court and the Commissioner expressly find that no deduction was taken for the capital losses.

The Circuit Court of Appeals for the Ninth Circuit had the questions here at issue before it, in the case of *McLaughlin* v. *Pacific Lumber Company*, 66 Federal (2d) 895, except that the 1928 Act and the rules promulgated thereunder were not involved. The government in that case contended:

1. "That the losses of a parent corporation in connection with the liquidation and dissolution of a

have justified the petitioner there in claiming the loss on dissolution to be cost less the value of assets taken over. But the fact remains that the petitioner there did not make such a claim in its petition, and did not urge it in argument. The point, therefore, was not in issue. Nor was it in issue in the case of *Burnet* v. *Aluminum Goods Mfg. Company*, supra, decided by this court. So neither of the last-mentioned cases are decisive of the issue discussed in this subdivision of our brief, nor was the statute of 1928 or the rules promulgated thereunder, there involved or considered.

## CONCLUSION

The petitioner does not seek a double deduction as we have heretofore demonstrated. Had the petitioner's subsidiaries operated at a profit, and paid taxes on such profit annually during the consolidated return period, the petitioner would have again been compelled to pay a tax on liquidation, the converse is and ought, in equity and good conscience, to be true. The respondent held in the first instance and still insists, that the payment of the liquidating dividends after dissolution and affiliation broken, was an intercompany transaction. It has been the respondent's position at all times that we should be denied this deduction, because it is an intercompany transaction and the respondent's answer filed in the trial court so discloses. The opinion of the Circuit Court discloses that to have been the position of the respondent in that court and in his brief filed in opposition to the Writ of Certiorari in

this Court (at p. 6, under heading "Argument"), respondent said:

> "We submit that the Court below properly held that the petitioner was not entitled to deduct in 1929 any portion of the amount by which the cost of the stock and the advances to its subsidiaries exceeded the sums distributed although we believe the decision should have rested on the ground that under the commissioner's regulations no loss should be recognized upon the distribution by the subsidiaries."

Had the petitioner herein filed a separate return for itself and each of its subsidiaries in the year 1929, the parent corporation would have been entitled under any theory of the law, or departmental regulations, to the deduction here claimed.

It is therefore, respectfully submitted that under the Statute and under the regulations, no other result can be reached than a reversal of the Judgment of the Circuit Court and an affirmance of the decision of the trial court in favor of the taxpayer. It is earnestly represented, moreover, that the Courts should permit no shadow of doubt to fall upon the inviolability of the consolidated returns regulations—contractual in their effect as between government and taxpayer, legislative in their force upon both, and ever since their promulgation relied upon by affiliated groups of corporations throughout the land as stating the exact tax consequences of transactions which, without such assurances, they might not have undertaken.

It is therefore respectfully submitted that the judg-

ment of the Circuit Court should be reversed with directions to affirm the judgment of the District Court.

Respectfully submitted,

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# APPENDIX

REVENUE ACT OF 1928, C. 852, 45 STAT. 791, 822, 831

SEC. 115. DISTRIBUTION BY CORPORATIONS.

* * * * * *

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

SEC. 141. CONSOLIDATED RETURNS OF CORPORATIONS—1929 AND SUBSEQUENT TAXABLE YEARS.

(a) *Privilege to file consolidated returns.*—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year 1929 or any subsequent taxable year, in lieu of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to

all the regulations under subsection (b) prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) *Regulations.*—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(c) *Computation and payment of tax.*—In any case in which a consolidated return is made the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under subsection (b) prescribed prior to the date on which such return is made. Only one specific credit, computed as provided in section 26 (b), shall be allowed in computing the tax.

TREASURY REGULATIONS 75, PROMULGATED UNDER THE REVENUE ACT OF 1928.

APPLICATION OF REGULATIONS

*(a) 1929 and Subsequent Years.*

These regulations are applicable only to the taxable year 1929 and to subsequent taxable years.

ART. 2.—*Definitions.*

* * * * *

(c) *Consolidated Return Period.*

The term "consolidated return period" means the taxable year 1929, or any subsequent taxable year, for which a consolidated return is made or is required.

ART. 34.—*Sale of Stock—Basis for determining Gain or Loss.*

(a) *Scope of Article.*

This article prescribes the basis for determining the gain or loss upon any sale or other disposition (hereinafter referred to as "sale") by a corporation which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for the taxable year 1929 or any subsequent taxable year, of any share of stock issued by another member of such group (whether issued before or during the period that it was a member of the group and whether issued before, during, or after the taxable year 1929), and held by the selling corporation during any part of a consolidated return period. (For the basis in the case of sales of bonds, see article 35.) The paragraphs of this article are applicable to sales during different periods of time, as follows:

(1) Sales which do not break the affiliation—paragraph (b);

(2) Sales which break the affiliation and which are made during the period that the selling corporation is a member of the affiliated group (whether or not during a consolidated return period)—paragraph (c);

(3) Sales made after the selling corporation has ceased to be a member of the affiliated group—paragraph (d).

(b) *Sales which do not Break Affiliation.*

If notwithstanding any such sale the issuing corporation remains a member of the affiliated group, such basis shall be determined and adjusted in the same

manner as if the selling corporation and the issuing corporation had never been members of an affiliated group. (See sections 111 to 115, inclusive, of the Act, and articles 561 to 629, inclusive, of Regulations 74.)

(c) *Sales which break Affiliation made while Selling Corporation is Member of Group.*

If the sale is made during a period which the selling corporation is a member of the affiliated group (whether or not during a consolidated return period), and if, as a result of such sale, the issuing corporation ceases to be a member of the affiliated group, such basis shall be determined as follows:

(1) The aggregate basis of all shares of stock of the issuing corporation held by each member of the group (exclusive of the issuing corporation) immediately prior to the sale, shall be determined separately for each member of the group, and adjusted in accordance with the Act (see sections 111 to 115, inclusive, of the Act, and articles 561 to 629, inclusive, of Regulations 74):

(2) From the sum of the aggregate bases, as determined in paragraph (1) above, there shall be deducted the aggregate of the losses of such issuing corporation sustained during each of the consolidated return periods (including only the taxable year 1929 and subsequent taxable years) after such corporation became a member of the group and prior to the sale of the stock, to the extent that such losses could not have been availed of by such corporation as a net loss in computing its tax for such periods if it had made a separate return for each of such periods;

(3) The total aggregate basis of all shares of stock, after making the deduction under paragraph (2), shall then be allocated to each member of the group which

holds stock in the issuing corporation, in the ratio that the basis of each, as determined under paragraph (1), is to the sum of the bases of all;

(4) The aggregate basis as determined under paragraph (3) for each member of the group shall then be equitably apportioned among the various classes of stock held by such member according to the circumstances of the case—ordinarily in the ratio that the basis of each class of stock held by it at the time of the sale is to the sum of the bases of each class of stock held by it;

(5) The basis of each share of stock of each class held by a member of the group shall then be determined by dividing the basis apportioned to such class under paragraph (4) by the total number of shares of such class held by it.

* * * * * *

(d) )*Sales after Selling Corporation has ceased to be a Member of the Group.*

If the sale is made after the selling corporation has ceased to be a member of the affiliated group, such basis shall be determined in accordance with paragraph (c) of this article, except that—

(1) The aggregate basis (under subparagraph (1) of such paragraph) shall be determined for all shares of the issuing corporation held by each member of the group immediately prior to the time the selling corporation ceased to be a member of the group (rather than immediately prior to the sale); and

(2) The allocations (under subparagraph (3) of such article) shall be made to each member of the group which held stock of the issuing corporation immediately prior to the time the selling corporation ceased to be a member of the group (rather than to the

members holding such stock at the time of the sale); and

(3) The basis of each share of stock held by the selling corporation (determined, as above, as of the time the selling corporation ceased to be a member of the group) shall then be adjusted in accordance with the Act (see, particularly, sections 111 to 115, inclusive, of the Act and articles 561 to 629, inclusive, of Regulations 74) in order to determine the basis at the time of the sale.

(c) *Limitation on Adjustment For Losses.*

No deduction shall be made under paragraph (c) (2) of this article, in the event of a consolidated net loss which was sustained more than two years prior to the close of the taxable year during which the sale was made and which was not availed of by the members of the affiliated group in computing the tax for the consolidated return period, for that portion of such net loss which the losses of the subsidiary for the year in which such net loss was sustained bears to the aggregate losses of each of the members of the group.

ART. 35.—*Sale of Bonds—Basis for determining Gain or Loss.*

In the case of a sale or other disposition by a corporation, which is (or has been) a member of an affiliated group which makes (or has made) a consolidated return for the taxable year 1929 or any subsequent taxable year, of bonds issued by another member of such group (whether or not issued while it was a member of the group and whether issued before, during, or after the taxable year 1929), the basis of each bond, for determining the gain or loss upon such sale or other disposition, shall be determined in accordance

with the Act (see particularly, section 113 of the Act), but the amount of any loss otherwise allowable shall be decreased by the excess (if any) of the aggregate of the deductions computed under paragraph (c) (2) of article 34 over the aggregate of the basis of the stock of the issuing corporation as computed under paragraph (c) (1) or (d), as the case may be, held by the members of the affiliated group. (See, also, article 40 (c), relating to disallowance of loss upon intercompany bad debts.)

ART. 37.—*Dissolutions—Recognition of Gain or Loss.*

(a) *During Consolidated Return Period.*

Gain or loss shall not be recognized upon a distribution during a consolidated return period, by a member of an affiliated group to another member of such group, in cancellation or redemption of all or any portion of its stock; and any such distribution shall be considered an intercompany transaction.

(b) *After Consolidation Return Period.*

Any such distribution after a consolidated return period, whether in complete or partial liquidation, shall be treated as a sale of the stock, and the adjustments specified in articles 34 and 35 will be made, and article 36 will be applicable.

ART. 40.—*Bad Debts.*

(a) *Resulting From Transactions During Consolidated Return Period.*

Intercompany accounts receivable or other obligations which are the result of intercompany transactions during a consolidated return period shall not be.